ORIGINAL

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PROCEEDINGS BEFORE

THE SUPREME COURT

OF THE

UNITED STATES

CAPTION: BOB REVES, ET AL., Petitioners, v.

ARTHUR YOUNG & CO.

CASE NO: 88-1480

PLACE: Washington, D.C.

DATE: November 27, 1989

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IN THE SUPREME COURT OF THE UNITED STATES

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BOB REVES, ET AL., :

Petitioners :

v. : No. 88-1480

ARTHUR YOUNG & CO. :

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Washington, D.C.

Monday, November 27, 1989

The above-entitled matter came on for oral argument before the Supreme Court of the United States at 12:59 p.m.

APPEARANCES:

JOHN R. McCAMBRIDGE, ESQ., Chicago, Illinois; on behalf of the Petitioners.

MICHAEL R. LAZERWITZ, ESQ., Assistant to the Solicitor General, Department of Justice, Washington, D.C.; as amicus curiae, supporting the Petitioners.

JOHN MATSON, ESQ., New York, New York; on behalf of the Respondent.

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P R O C E E D I N G S

(12:59 p.m.)

CHIEF JUSTICE REHNQUIST: We'll hear argument now in No. 88-1480, Bob Reves v. Arthur Young & Company.

Mr. McCambridge.

ORAL ARGUMENT OF JOHN R. McCAMBRIDGE

ON BEHALF OF THE PETITIONERS

MR. McCAMBRIDGE: Mr. Chief Justice, and may it please the Court:

The issue in this case is whether uninsured demand notes which were advertised as investments and purchased by thousands of ordinary people for more than $10 million are securities.

Under any proper application of the 1934 act, these notes are securities and their purchasers are protected. Let me briefly touch the facts.

These notes were sold by the Farmer's Co-Op of Arkansas and Oklahoma for more than 25 years. They were uninsured and unsecured. The Co-Op is not a regulated financial institution. It's not a bank; it's not a savings and loan. It's in the business of buying and selling farm products.

Over 25,000 people were solicited every month. They were told in prominent advertisements, "This is an investment program. These notes are investments. Buy

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these notes as investments."

The notes paid a variable rate of interest which was adjusted every month by the Co-Op's management. The notes were sold to members of the Co-Op and to non-members.

Let me make a point on the membership. To be a member of the Co-Op cost nothing more than $5.00. A simple $5.00 payment. About half the people in the local community were members of the Co-Op.

At the time of the bankruptcy of the Co-Op, 1,685 people held notes which they had purchased for over $10 million.

QUESTION: What was the money raised for? Operating funds?

MR. McCAMBRIDGE: The money was used both in the day-to-day operation of the Co-Op and to make some capital purchases. There was no identification in the advertisements as to the purpose for which the funds would be used.

Let me turn to --

QUESTION: Do you have any statistics on the number of non-members -- percentage of notes that were sold to non-members, as opposed to members?

MR. McCAMBRIDGE: There is nothing in the record to delineate the exact division. No, Your Honor.

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QUESTION: Anything to indicate that the number of notes sold to non-members was substantial or significant, or any finding like that at all?

MR. McCAMBRIDGE: Well, the finding by the court was a general finding that the notes were offered -- I'm sorry -- sold to the public. In terms of how many of those purchasers were also members of the Co-Op, there is no precise record.

Again, to be a member of the Co-Op, it's a $5.00 purchase. This was a rural community and the Co-Op operated feed stores and things like that. So, someone would buy a membership for $5.00, because at the end of the year you could get a patronage dividend if your purchases were sufficient.

The population of the community in which the Co-Op had outlets and was headquartered was about 70,000 -- 23,000 people were Co-Op members. If you add in members of their families, et cetera, you could almost say that the general public and the membership of the Co-Op was almost coextensive.

But, in direct response, Justice Kennedy, to your question, it is not absolutely clear.

QUESTION: What was the name of the city in which the Co-Op was located?

MR. McCAMBRIDGE: Van Buren, Arkansas, and it

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had outlets in three cities in Oklahoma.

QUESTION: And how did they sell?

MR. McCAMBRIDGE: I'm sorry, Your Honor.

QUESTION: How did they sell? Did they just --

MR. McCAMBRIDGE: People would come to an outlet of the Co-Op.

QUESTION: Didn't they advertise?

MR. McCAMBRIDGE: Yes, they were advertised.

QUESTION: And did they use any kind of an agency to sell them?

MR. McCAMBRIDGE: No, they were sold directly by the Co-Op. The advertisement is at page 4 of the -- I'm sorry, page 5 of the joint appendix, and substantially the same advertisement appeared in every issue, every month.

QUESTION: You can say the people made their own Co-Op directly at the outlet?

MR. McCAMBRIDGE: Well, we think not, Your Honor. There was no -- these investments, or these sales of demand notes, were never advertised as a loan. They were never described as a loan. The Co-Op never said, please loan us your money.

QUESTION: On their face they were a loan, were they not?

QUESTION: It said that on their face, they were notes.

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MR. McCAMBRIDGE: Notes? Yes, that's what it said. And notes can be either investments --

QUESTION: -- you think that. A note involves an obligation to pay some money, doesn't it?

MR. McCAMBRIDGE: This is an obligation to pay money.

QUESTION: On demand.

MR. McCAMBRIDGE: On demand. That was offered and solicited from members of the general public, 25,000 people every month, advertised as an investment. In our view, the difference -- the critical difference here is going to be whether these were investment transactions or simple commercial loans.

QUESTION: What's the maturity date of a demand note?

MR. McCAMBRIDGE: A demand note has no maturity date. The exclusion relied upon by Arthur Young -- if the Court were to accept Arthur Young's invitation to read it absolutely literally -- the demand notes would not be covered; they are not mentioned in the exclusion. And, in fact, the record in this case indicates --

QUESTION: Is there a general case law to the effect that a demand note is mature on issuance, in effect?

MR. McCAMBRIDGE: No.

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QUESTION: The general field of bills and notes?

MR. McCAMBRIDGE: A demand note can be presented for payment immediately. It has no definite maturity date. The effect of that is that there is no single date upon which people would present them for payment. It was up to the purchaser and the holder, really, to decide when to present them.

QUESTION: What do you think the purpose was of the exclusion by Congress of notes with a maturity date of less than nine months?

MR. McCAMBRIDGE: The purpose of the exclusion was to exclude commercial paper not offered to the public. And the basis for that conclusion is --

QUESTION: Well, what if there were a note due and payable in six months that was for investment purposes.

MR. McCAMBRIDGE: We believe that a note offered as an investment and widely sold with a six-month maturity would be a security. It would not be excluded by --

QUESTION: Notwithstanding the language in the statute, which is rather clear.

MR. McCAMBRIDGE: Well, Your Honor, the statute has a couple of things that are pertinent. Number one is the introductory phrase, "unless the context otherwise requires," which has been interpreted consistently by this

Court and others to require an investigation into the circumstances of the transaction to see whether regulation or treatment of the instrument as a security would fulfill or would be necessary to satisfy Congress' purpose to protect investors.

QUESTION: Have the exceptions been construed in the light of that introductory phrase?

MR. McCAMBRIDGE: Every lower court -- federal --

QUESTION: Has this Court ever done that?

MR. McCAMBRIDGE: This Court has not addressed this specifically. The cases to which I refer are cases dealing with the definition of a security in which this Court has expressly investigated the context of the transaction to see whether defining the instrument as a security would be consistent or required by Congress' purpose to regulate investors.

QUESTION: Mr. McCambridge, I'm sure that the purpose of this thing was to exclude commercial paper. But they could have said that. They could have said it doesn't include commercial paper.

But they said -- well, I assume what they said is that that's going to be very complicated and require a case-by-case examination -- we will adopt a rule. It may not be perfect, but it will surely get virtually

everything that's commercial paper. It may be rough at the edges.

And I think you're coming before us with one of the edges. I mean, maybe this isn't commercial paper, but it does fall within the rough rule that this exception seems to say. If it's less than nine months, it's just not going to be deemed an investment.

MR. McCAMBRIDGE: Well, the first point. I'd like to bring you back to the fact that on an absolutely literal reading, which I think is what you're talking about, demand notes are not mentioned. Second --

QUESTION: Well, isn't it true that on a literal reading even a note with a term, once the term arrives, it becomes a demand note thereafter doesn't it?

MR. McCAMBRIDGE: I think that the statute says at the time of issuance and deals with notes with fixed terms. And you can see from the record here that purchasers will treat demand notes in a variety of ways. Sometimes they may be, as Arthur Young argues, more like a short-term note. Other times, more like a long-term note.

QUESTION: Well, do you want to rest on the proposition that no demand note is covered by the exception so that case-by-case we're going to have to look at demand notes to see if they're investments?

MR. McCAMBRIDGE: I don't think a literal

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reading is the proper reading. I think that the proper reading is that to conclude that the exclusion means commercial paper not offered to the public as a general matter -- that's the proper way to approach this. And then to examine notes -- other notes -- with an eye towards determining whether they are investments or commercial.

QUESTION: Well, to say that you're not going to be literal in one respect where you obviously can't be literal is not to say that you're not going to be literal in any respects, which is what you are urging upon us.

MR. McCAMBRIDGE: I am suggesting that the explicit language of the statute requires -- Congress' language -- requires an examination of context. And the reason that Congress requires that is because, as this Court has noted in several cases, there is a need to be flexible in this area to both effectuate Congress' purpose and to deal with the many different sorts of financial instruments which promoters devised to separate people from their money, which is what happened here.

This Court has indicated in the Securities Industry Association case in dicta that the exclusion about which we are talking now is an explicit exception for commercial paper.

And the definition used by Congress came from

the Federal Reserve Board and investment bankers who were absolutely clear when they appeared before Congress. They said, this is about commercial paper; we want an exemption for commercial paper. And they persuaded Congress that that would be appropriate because, they said, commercial paper is not generally available to the public. It's not sold to the public, it's not offered to the public.

They said you and I -- in talking to the members of Congress -- we are not going to lose any money if we buy -- if this exclusion goes in because we do not buy commercial paper. These are for sophisticated professionals.

On the literal point -- let me turn to the effect of the test as proposed by Arthur Young. Arthur Young does want this read absolutely literally, except for the demand note point which I've already noted.

And Arthur Young's conclusion is that the only thing that matters is maturity. Context doesn't matter. Congress' purpose doesn't matter. How they are advertised doesn't matter. Whether people buy them as investments doesn't matter. The only thing that is of any concern is this nine-month bright line test.

And every lower court which has taken a look at this has said that's a perverse result which would be at odds with the purpose of this statute. Specifically,

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every three-year note which a consumer issues in connection with his purchase of a car would be a security, subject to regulation, while public offerings of, say, 45-day investment notes, which is exactly the scheme that Ponzi used in the '20s in Boston -- 45-day notes publicly offered as investments -- would be unregulated.

The analysis that this Court has used in all of its decisions concerning the proper definition of a security has been to give effect to what Congress was trying to do. In this case, these are securities and --

QUESTION: Mr. McCambridge, can I ask you a factual question --

MR. McCAMBRIDGE: Yes.

QUESTION: -- that I was a little unclear on? The note, the actual form of note they have has a place to insert the interest amount in it. And I guess your advertisement -- the advertisement you referred to, referred to a 14 percent interest rate.

Does that mean that the 14 percent -- say such a note was given to a depositor or lender -- does that mean the 14 percent would just stay there until the money was withdrawn and a different deposit made? Or, would -- as I understood it, also, they adjusted the interest rate periodically. Would the interest fluctuate for a particular depositor without the necessity of another note

being executed?

MR. McCAMBRIDGE: Yes. What happened, they issued a note with whatever the quoted rate at the time was, but in practice and in the advertisement, the Co-Op would change in response to market conditions.

QUESTION: And that would be either up or down?

MR. McCAMBRIDGE: Up or down.

QUESTION: And that was -- that was -- because it doesn't really fit the language of the note itself.

MR. McCAMBRIDGE: No, it does not.

QUESTION: Yeah. And the note does use the word "maturity" I notice also, which I guess would be the time of demand is what they're referring to.

MR. McCAMBRIDGE: Well, I think that Arthur Young is right on one thing. These probably were purchased in a stationery store, or something like that. There's no record evidence of it.

QUESTION: Yes.

MR. McCAMBRIDGE: And I think if you look at it, "demand" seems to be inserted --

QUESTION: Yes.

MR. McCAMBRIDGE: -- by the Co-Op. So what I think is that they were trying to say that these are demand notes and the fact that it has some printed language referring to maturity, I don't think is

significant.

QUESTION: See, but you could argue, I suppose that if the demand isn't made within the nine months, the maturity date was more than nine months after issuance.

MR. McCAMBRIDGE: In fact, that's what happened here.

QUESTION: Yeah.

MR. McCAMBRIDGE: More than 80 percent of the notes purchased were not redeemed within the succeeding year. The record upon which the lower court decided this on summary judgment included dozens of affidavits from note holders saying, you know, we used our life's savings to buy these. We thought they were investments, we treated them as long-term investments. That's what they were to us.

And there's no evidence of any short-term redemptions. There is nothing in the record on that point.

QUESTION: But, as you point out, the statute requires maturity to be determined at the time of issuance -- a maturity at the time of issuance of not exceeding nine months. So you really couldn't wait, under the statute, to see when it's cashed in, in order to determine. You have to make some judgment one way or the other at the outset.

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MR. McCAMBRIDGE: If there is a maturity, and there is none with demand notes.

I'd like to reserve the rest of my time.

QUESTION: Very well, Mr. McCambridge.

Mr. Lazerwitz.

ORAL ARGUMENT OF MICHAEL R. LAZERWITZ

AS AMICUS CURIAE SUPPORTING THE PETITIONERS

MR. LAZERWITZ: Thank you, Mr. Chief Justice, and may it please the Court:

There should be little doubt from a common sense viewpoint, and also from a legal standpoint, that the transactions in this case are precisely the type of financial activities that Congress sought to regulate through the securities laws.

The Farmer's Co-Op was an agricultural cooperative in the business of marketing and supplying farm products for its members. It was not in the banking or financial services business. In order to raise capital and also to cover operating expenses, the Co-Op marketed and sold demand notes -- interest-bearing demand notes to the public -- the public being its members and others with whom it did business.

By the time of the Co-Op's demise, some 1,600 individual investors hold Co-Op notes having a total face value of some $10 million --

QUESTION: Would you be arguing the same if there were some bank that was willing to supply working capital to this Co-Op and every month advanced money to them? Or -- if there were just a single lender, would you be thinking --

MR. LAZERWITZ: Justice White, if in fact the case were as you posited with just a bank, a single bank, loaning money to the Co-Op to cover operating expenses, in our view, under the Second Circuit's family resemblance test, which we urge this Court to adopt, those notes would not be covered.

I only mentioned the comparison to a bank in my opening remarks because there is a hint, in the respondent's brief, that these transactions were like a banking transaction -- were like banking transactions. And they are not.

The Co-Op was not governmentally regulated or an insured financial institution.

QUESTION: But it was still securing its working capital through these notes.

MR. LAZERWITZ: Yes. That's clear from the record. The principal question presented in this case, it seems to us, is whether the notes qualify as securities under the statutory definition of note or whether they should be treated under the residual category of

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investment contract.

In our view, these notes do qualify under the statutory definition of note and are securities. And in reaching that conclusion we urge this Court to take the occasion to adopt the Second Circuit's family resemblance test as the proper approach for determining whether an instrument labeled a note is a security. All agree that the security --

QUESTION: Under that test, what would guide judges in knowing what's on the list of family resemblances?

MR. LAZERWITZ: Well, first of all, Justice O'Connor, what is on the list today -- the different examples that the Second Circuit has previously put on the list and also, as Judge Friendly made clear in the Chemical Bank case-- the examples on the list, in his words, were not graven in stone. The point was that it's just a starting point.

The Second Circuit has picked out from the case law, from the commentary, and from experience, those types of notes that all should agree are not covered under the securities laws. And, in fact, the Chemical Bank case took the next step and added what might be considered one of the more important categories, which is sort of what Justice White was mentioning before, and that is a loan

transaction between a bank and a borrower.

QUESTION: Well, is it just what Congress should have included if it had made a list? I mean, what stands behind that list?

MR. LAZERWITZ: What stands behind that list are, first of all, the language of the statute. And it's important for us to start -- and one of the reasons why we endorsed the family resemblance test is that of all the approaches available it must closely conforms to the statutory language.

QUESTION: Well, if the language of the statute is a starting point, then what about the effect of a maturity date of less than nine months?

MR. LAZERWITZ: The maturity -- the statutory exclusion in the '34 act, in our view, as Petitioners mentioned before that statutory exclusion is limited to commercial paper. This court has suggested as much in the Securities Industry Association case, and we would agree with that suggestion for several reasons.

First of all, the exclusion uses the phrase -- and it's a four-term phrase -- note, draft, bill of exchange or banker's acceptance. That four-term phrase comes from something. We suggest it comes from Section 13 of the Federal Reserve Act and the Federal Reserve Board's corresponding Regulation A.

Those words themselves tell you that Congress had something in mind other than any note with a maturity of less of nine months.

QUESTION: Well, why? You know, it says note. Why on earth would one draw the inference when Congress says a note with a maturity of less than nine months you would draw the opposite inference, that they had something else in mind?

MR. LAZERWITZ: Well, because they said any note, draft, bill of exchange or banker's acceptance. And those four terms, next to each other, mean something. They mean -- those are -- that's Congress' way of describing commercial paper.

QUESTION: It's a very strange way to describe it since "note" is a generic term.

MR. LAZERWITZ: Well, so are -- and, again, so are bill of acceptance or banker's draft, but all -- describing the types of instruments that in the early 1930s Congress knew covered commercial paper. And there's more --

QUESTION: But also, a note covers more than commercial paper.

MR. LAZERWITZ: Yes. A note -- only certain types of notes are also commercial paper. Notice, obviously, the broader category.

But there is something other than the language and the structure of that particular exclusion. The legislative history shows that Congress put the exclusion first in the '33 act in response to a commercial -- the financial community's concern of regulating commercial paper. And commercial paper, as it was then and as it is today, is not ordinarily traded and sold between the ordinary investing public.

Apart from both the language -- we urge the Court that the structure of that exclusion means something. Apart from the legislative history, the purposes of the securities laws call for that exclusion to be read the way we suggest, because it would make no sense.

This Court has held since the Joiner case 45 years ago, going up through Landreth, that we cannot forget the purposes of the securities laws. I submit it would make no sense to include within that exclusion the public offering of eight-month notes offered to the general public.

QUESTION: Maybe not unless you're trying to get a rule that the courts can easily apply. As I understand your thesis, though, once we -- if we were to adopt the family resemblance test and adopt the rest of your case, the nine-month provision, as it applies to notes, would

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have no function whatever, would it?

MR. LAZERWITZ: No, that's not true. Under the --

QUESTION: What function would it have, because, as you say, you would just look to see if it has a family resemblance and the nine months doesn't matter.

MR. LAZERWITZ: Under the family resemblance test with respe a short-term notes, the test would proceed as follows.

The test first starts with the statutory language defining a security as including any note, and then takes account of the exclusionary language, and then construes those provisions in light of the preparatory clause unless the context otherwise requires.

For example, a note having in it a maturity date of less than nine months is initially presumed not to be a security, following the statutory language. But then the party seeking to overcome that presumption, for example, in this case, would have to show that the context otherwise requires.

The first thing that party would show is, look, this isn't commercial paper, so I can't be shut out under the securities laws for that reason. The second step -- or, actually, the way the test works, it would have been the first -- my note doesn't resemble both types of notes

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that all would agree fall outside the scope of the securities laws.

So, we think the exclusionary language does have a place. Although it hasn't come up yet, under the Second Circuit's test, the Second Circuit used the phrase "fits the general description of commercial paper." So there could be -- it hasn't happened yet, but there might be an instrument that for one particular reason doesn't qualify as commercial paper within the strictures of let's say the SEC's 61 release.

But it otherwise might be so close that perhaps it shouldn't be covered by the securities laws. That case hasn't come up yet. But we do think that the language does have meaning and we disagree with any suggestion that because of the way we interpret the exclusionary clause that it writes it out of the act.

It doesn't, and in fact Judge Friendly, in the Exchange National Bank case and Chemical Bank, made clear that that was his disagreement with some other courts, that threw up their hands and said, well, I guess we're just writing this out of the act.

The Second Circuit's test does not, and it still plays a part, as it must, because it is written into the law and we can't disregard the law.

QUESTION: So, if something is called a note on

its face, it is presumed to be a security?

MR. LAZERWITZ: Yes, Justice White.

QUESTION: And -- but then you run to the exclusion -- to the exclusion which overcomes that presumption with respect to short-term notes?

MR. LAZERWITZ: It changes the presumption that flips the burden back to the party seeking coverage. In this case it would be the plaintiffs.

QUESTION: So he has to prove that in this context the exclusion just doesn't apply?

MR. LAZERWITZ: Right. The first thing would be -- just to answer that question -- that it's not commercial paper.

QUESTION: Yes.

MR. LAZERWITZ: Thank you.

QUESTION: Thank you, Mr. Lazerwitz.

Mr. Matson, we'll hear now from you.

ORAL ARGUMENT OF JOHN MATSON

ON BEHALF OF THE RESPONDENT

MR. MATSON: Mr. Chief Justice, and may it please the Court:

Petitioners and the government here want the Court to decide this case without looking at the plain language of the 1933 act.

If, as this Court has said, the starting point

is the language of the statute itself, then in this case that's the ending point because the statutory language is very clear. It excludes in the 1934 act from the definition of a security notes which have a maturity at the time of issuance of not exceeding nine months. These demand notes fit squarely into that exclusion.

And, Justice O'Connor, your question earlier about maturity, the case law is clear both nationally and in Arkansas, which would apply here, that with a demand note maturity is measured at the time of issuance. In other words, the demand note matures when it's issued. Those cases are cited at page 10 of our brief.

QUESTION: In what context does that question come up? How do you have a case that involves the issue of whether a demand note is mature upon its issuance?

MR. MATSON: The several Arkansas cases we cite are statute of limitations cases. They certainly don't arise in this context. There is no federal litigation involving --

QUESTION: Well, I don't see how you can have --

MR. MATSON: -- demand notes as securities, and the courts have determined -- and this is a common-law rule -- that when something is on demand it matures at the time it's issued.

QUESTION: I thought that -- maybe it's just my

California experience, but I had thought the rule was just the opposite, that the statute of limitations begins to run from the time a demand is made.

MR. MATSON: At least not in Arkansas and, as we understand, the general -- I don't know what, Justice Kennedy, the California particular rule is, but for the purposes of these notes --

QUESTION: So, in Arkansas the statute of limitations on a demand instrument runs from the date of its issuance?

MR. MATSON: The date of its issuance. That isn't -- this isn't a statute of limitations question. That's just simply the source of the body of law that says a demand note matures when it's issued. So, for purposes of the statute in this case, it has a maturity of less than nine months. Now --

QUESTION: May I ask, what is the statute of limitations in Arkansas on -- on a demand note?

MR. MATSON: I don't know, Justice Stevens.

QUESTION: But it means the same --

MR. MATSON: It's never less --

QUESTION: -- say, if it was five years, if they left the money in the bank for five years, they could never get it back?

MR. MATSON: I don't know the answer.

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QUESTION: It seems rather strange.

MR. MATSON: That was never -- never a question in this case. But the question --

QUESTION: But if they leave the money on deposit for longer than the statutory limitations period, they forfeit the money under your --

MR. MATSON: I don't know. I'm sorry.

QUESTION: But that's the -- that's the net effect of the rule that you're telling us they adopt there.

MR. MATSON: The issue, for purposes of this case --

QUESTION: Yeah.

MR. MATSON: -- because that question never came up was simply how do you measure maturity for purposes of he 1934 act. And the answer for these demand notes is they mature immediately; therefore, they're within the nine-month rule.

QUESTION: What we need here is -- what we need is an Arkansas lawyer instead of lawyers from Chicago and New York.

(Laughter.)

MR. MATSON: Well, the question -- the question, Justice --

QUESTION: Me being from the Eighth Circuit,

why, what's happened to my lawyers out there?

MR. MATSON: The question, Justice Blackmun, for purposes of this case is simply to measure maturity for purposes of that statutory language. The statutory language says a maturity of less than nine months. These have immediate maturity.

Given that fact, any other result can occur only by ignoring the statutory language and ignoring legislative history. And what Petitioners and the government --

QUESTION: May I ask you -- may I ask you just two quick questions? Do you cite the Arkansas cases that give this holding on --

MR. MATSON: Yes. They are at page 10 of our brief.

QUESTION: Thank you. Secondly, just out of curiosity because you're certainly free to make the point, but did you argue in the court of appeals that you came within the exclusion for paper that was less than nine months maturity?

MR. MATSON: Yes.

QUESTION: You did? Because they didn't address that, as I remember it, did they?

MR. MATSON: That was -- that was part of the argument we were making. To avoid this plain language

result, Petitioners and the government would have the Court read into the 1934 act language that simply is not there. And they would have the Court do this in two ways.

Either to take an exemption from registration, what's been referred to as the commercial paper exemption, out of the 1933 act and read it as if it were in the 1934 act.

Or, alternatively, they'd take four words that are in the exclusion -- note, draft, bill of exchange, bankers of acceptance -- and say what Congress really meant by those four phrases was commercial paper.

Now, first, in the 1934 act when Congress wanted to refer to commercial paper, it did. This is not -- I apologize -- in our brief, but in rereading the original '34 act in preparation for argument, the phrase commercial paper is there. It's in Section 15 of the act where Congress was granting the SEC authority for rulemaking with respect to certain market-making activities except for exempt securities and commercial paper.

In other words, when Congress wanted to use the phrase, it knew how to use it and it did. Would it have, with that background, have used note, draft, bill of exchange and bankers of acceptance to mean commercial paper and only commercial paper when elsewhere in the same statute it used those words specifically?

The two statues, the 1934 and '33 act, have very different purposes. The 1934 act was adopted to regulate exchanges. Short-term notes were not traded on exchanges. They would not have been subject to the act. They were excluded from the definition. The 1933 act, on the other hand, regulates the offering of securities.

And although at the time the statutes were adopted short-term notes were not traded, they were offered. So the 1933 act, with its purpose of regulating the offering of securities, includes short-term notes in the definition and only excludes certain of those notes from registration. The 1934 act, on the other hand, with its purpose of regulating the exchanges, didn't need to address short-term notes, which simply were not traded.

The government also suggests that the Court ought to read into the 1934 act language that's not there to prevent frauds from being committed with short-term instruments. The fact of the matter is the 1933 act itself provides for the SEC and for the investing public protection with respect to the offering of short-term instruments.

There is no reason, in other words, for this Court to read into the 1934 act language that isn't there to protect the public because for that purpose they're protected under the 1933 act.

QUESTION: Why isn't that so for everything?

MR. MATSON: I'm sorry, Justice White?

QUESTION: Why isn't that so for everything covered by the 1934 act? I mean, why couldn't you say, well, you just don't need the 1934 act then?

MR. MATSON: At the time the act was adopted, it was focused on regulating exchanges. The use of the act today, most specifically Section 10(b), is very different than it was envisioned in 1934.

QUESTION: I see.

MR. MATSON: The real protection it applies is for the defrauded seller who isn't protected under the 1933 act, and that isn't the case that we have here.

Only if the Court rejects the plain language analysis we're making of the 1934 act does it have to face the perplexing issue for the lower courts and practitioners and commentators of just what notes are securities. It has been universally accepted that some instruments denominated note are securities.

The corporate capital note publicly offered and traded on the exchanges would be thought by all to be a security. On the other hand, a consumer finance note, a home mortgage note, a commercial borrowing note were generally thought not to be a security. And --

QUESTION: Do you think that that's right, that

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you would not consider them securities?

MR. MATSON: Yes, that's right.

QUESTION: That is right?

MR. MATSON: The purpose --

QUESTION: But if that's right, if you can use that introductory phrase -- I'm not sure it was meant for that purpose, but if you can use that introductory phrase to ignore the plain language of the earlier portion of this provision, why can't you use it to modify the language of the exception as well? That's all --

MR. MATSON: Are we talking about the context language?

QUESTION: Yes, the context language.

MR. MATSON: Well, take the context language, Justice Scalia, at two points. One of the ways that Petitioners and the government are trying to use the context clause is to say you have to look at the context of the transaction and that's how you get to the commercial paper exclusion.

However the context clause is used -- and this Court, for example, in National Securities suggested it was statutory context not transactional context -- would Congress have let -- would Congress have intended the context clause to be used in a way where commercial paper is always excluded from the definition? That wouldn't be

how the context clause would be used.

If they wanted to exclude commercial paper from the definition, they would have said commercial paper. The context clause comes into play as the statute is applied in analyzing certain transactions.

A specific example, investment contracts, which is a term in the definition of security, has no particular -- intrinsic meaning. You have to look at the context of the transaction.

But that isn't the starting point. The starting point has to be the statute. And taking the plain language approach that we've taken to the meaning of the statute, if you extended that to say that any note, home mortgage note, consumer finance note, is a security probably is an absurd result and there is a stopping point at some place for the plain language rule, that's one of the stopping points.

But, certainly, since -- since the statutes were adopted, it has generally been accepted that not all notes can be securities. The statute, after all, was adopted to regulate instruments commonly thought to be securities. A home mortgage note has never been commonly thought to be a security.

So, the courts have been faced with this problem. It's never been before this Court, but the lower

--

QUESTION: Mr. Matson --

MR. MATSON: -- have struggled with how do you differentiate --

QUESTION: Mr. Matson --

QUESTION: May I interrupt you with that argument? If you rely on the kind of the consensus at the bar and the consensus among the lower courts to get home mortgage notes out of the plain language of the first part, don't you have precisely the same consensus, at least among the courts of appeals and the bar, on the nine-month exclusion?

Have there been any cases that disagreed with the Seventh Circuit decision in 1972 in the John Nuveen case or Judge Friendly's case in 1976? Haven't all the courts of appeals been consistent on that?

MR. MATSON: There certainly have been a lot of cases that disagree with Judge Friendly's decision on exchange --

QUESTION: Well, on the test.

MR. MATSON: -- on approach.

QUESTION: On the test.

MR. MATSON: Yes.

QUESTION: But not on the question of whether you just use plain language on the exclusion. They've

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been just as practical about the exclusion as you suggest is proper under the general language of the statute, haven't they?

MR. MATSON: In John Nuveen, which is really the first of the --

QUESTION: Right. In 1972.

MR. MATSON: -- cases, from John Nuveen on there have not been significant decisions. Courts have never, in the course of making that analysis, looked at the statutory language of the '34 act --

QUESTION: Well, Judge Friendly's case --

MR. MATSON: -- but never looked at --

QUESTION: -- certainly was not insignificant.

MR. MATSON: -- they've never looked at the history --

QUESTION: You don't think Judge Friendly's case looked at the history at all?

MR. MATSON: In terms of the --

QUESTION: And that's an --

MR. MATSON: -- 1934 act provision. The focus has always been on the '33 act and it's ignored the second purpose of the '34 act, that is, to regulate exchanges. It hasn't focused on the statutory language.

But, no, I think that distinction can be drawn. At one point the plain language of the statute says in the

exclusion if the note has a maturity of less than nine months, then it's not a security.

If you tried to apply that same approach to bring home mortgage notes in, then I think you -- you break the bounds of the plain language rule. But the two can be consistently applied.

QUESTION: I don't see how you break it if you say the words in the context -- unless the context otherwise requires reference to statutory context rather than transactional context.

MR. MATSON: Well, I think our argument is that -- the context clause focuses on statutory context.

QUESTION: Even in the general part?

MR. MATSON: In the first --

QUESTION: Even in the home mortgage note case?

MR. MATSON: In the first instance. And the focus of --

QUESTION: Then how do you get -- I don't understand how you handle the home mortgage note?

MR. MATSON: The focus -- maybe this focus helps. We know that the purpose of the adoption of the federal securities laws was to regulate those instruments commonly thought to be securities.

QUESTION: Right.

MR. MATSON: The capital note example I gave you

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would be commonly thought to be a security.

QUESTION: Right.

MR. MATSON: The home mortgage note would not be. But that same analysis I don't believe applies when you're dealing with the exclusion because there you're dealing with a congressional decision that these instruments were not traded on exchanges; therefore, they did not need to be part of the exclusion.

There have been arguments at times -- there is an amicus argument in this case from the state securities administrators that seems to suggest that home mortgages, consumer notes, and the like, would be securities. That's a very rare argument.

And where the state securities administrators get to that is trying to take the family resemblance test, which Petitioners and the government advocate, taking that test and saying that ought to be applied much more broadly. And that's one of the dangers, one of the flaws of that test -- is that it has no articulated rationale. It is a definition by default, as articulated by Judge Friendly.

QUESTION: Mr. Matson, has any court of appeal adopted your position with regard to demand notes?

MR. MATSON: The -- the demand note issue has never --

QUESTION: Yes or no?

MR. MATSON: No. Because the issue has never been before the court of appeals. Arguably there's been one demand note case ever in a court of appeals and that was the Zeller case in the Second Circuit and they didn't focus on this issue because of the peculiar facts of the case.

QUESTION: Has any district court adopted it -- your argument?

MR. MATSON: No, but once again, I don't believe there are district court cases involving demand notes. We have a very unusual instrument here and while the issues that this case presents are important in the broader range for many of the other notes that's traded, there is little use of demand notes as we have seen them.

And we have suggested that the -- that the test the Court should use as they distinguish between the notes that are securities and the notes that aren't follows from this Court's Landreth decision where it set up a two-stage test.

The Court said, first we'll look at the characteristics of the instrument and see if it has the characteristics of a security of that name. And if it does not, then we will treat it as an unusual instrument under this Court's Howey test.

So, it's a test that operates in two stages. It comes from the statute. It comes from this Court's decisions. It draws on 40 years of case law that's build up around the Howey decision. And it's a more positive and predictive test than the family resemblance test.

The Court in Landreth was speaking only to stock. The same issue had been in Forman ten years earlier, which was also a stock case. But the courts of appeals since Landreth have applied it to other enumerated instruments, and it's a workable test for all the various enumerated instruments in addition to stock.

And if the Court applies Landreth to notes, what it will have given the lower courts and practitioners is one framework in which all what is a security questions can be answered rather than a series of different tests for different types of securities.

The other tests that have been offered to the Court are not as grounded in the statute as this. They don't come out of this Court's decisions, and they are rigid in application.

For example, the most predominant of the lower court tests says an instrument must be either a commercial instrument or it's an investment instrument. That's a terribly difficult analysis with something like these demand notes which analytically don't logically fall into

either.

The investment commercial test also gets to the result by simply having a laundry list of factors from which a court can select, greatly reducing any predictive value of the test.

The family resemblance test which is advanced by the Petitioners and the government, as I said, has no articulated rationale. It really is a definition by default. It says if it's not like these six or seven instruments, then it's a security and that creates the danger of either you're going to apply those rigid items or a judge is free to do, if you will, as the securities administrators say, whatever appeals in a particular case, and that deprives the test of its predictive value.

Now, going back to the Landreth test that we advance in this case. The characteristics we would be talking about for a note would be the characteristics of instruments that are unquestionably securities and can be called either capital notes, bonds, debentures. They're all very similar.

They have these common characteristics: they tend to be long-term, they're often publicly traded, they have elaborate documentation surrounding them and they are perceived by users as being securities, which this Court has said on several occasions is an important factor in

evaluating whether something is a security.

Now, applying that to these demand notes. They're certainly not long-term. They were demand instruments. They were -- they wouldn't have -- they were not -- they would not have been publicly traded. You've seen the stationery store form that they're based on. And there's no evidence in the record that they were perceived by the Co-Op members that held them as being securities, no perception that the benefits of the securities laws followed them.

So, not having the characteristics of those notes and similar instruments that are undoubtedly securities, the Landreth test then goes to the second stage, the Howey test, which this Court said in Landreth was the appropriate test for all unusual instruments, which these demand notes certainly appear to be.

Howey focuses the test this way. On whether the instrument is an investment in a common enterprise made with the expectation of profit solely from the efforts of others.

Here something payable on demand doesn't carry with it the element of risk that is inherent in the concept of investment. What happened to these demand note holders -- the Co-Op went into bankruptcy -- is exactly the risk that anyone has where there is an obligation to

do something in the future. And that's true whether it's a co-op paying on demand notes or whether it's a corporation honoring a service contract on an automobile or a washing machine.

And that is contrasted by this Court's Forman decision, for example, with the kind of risk of market fluctuation that we tend to associate with securities. So, at the first level --

QUESTION: Well, there was some market fluctuation here on interest rates, wasn't there?

MR. MATSON: The interest rate was moved by the Co-Op in accordance with the money markets. But the interest rate constantly would change periodically and an investor could immediately demand their money if they didn't like where the Co-Op had moved the interest rate.

So, there isn't the kind of market risk there where somebody, for example, is locked into an interest rate over a long term or watches the value of capital appreciate or depreciate. It's simply the concept -- the right to immediate payment is at odds with the concept of investment.

Similarly, with the portion of the Howey test that speaks to expectation of profit through the efforts of others, this Court has dealt on several occasions with what profit means in a securities law context. And it has

said profit refers to either capital appreciation or earnings as in the sense of dividends.

Now, an economist could define profit very broadly. Probably benefits that I wouldn't even think of. But for securities law purposes, the Court has focused on the kind of profit one expects with a securities instrument. And that the Court identified, for example, in Forman as either capital appreciation or earnings in the form of dividends.

In the Court's Weaver decision, the Court dealt with an interest-bearing instrument and it distinguished for this purpose that instrument from the one before the Court in the Tcherepnin case which were withdrawable capital shares that paid dividends.

The Court drew that context, that with dividends there was the earnings of the entity, the anticipation of that, that didn't exist where what was being paid simply was -- simply was interest.

QUESTION: Mr. Matson, these notes had language in them to the effect that if they weren't paid at maturity, attorney's fees would be recoverable and included. That suggests, at least, that maturity is when an actual demand for payment is made.

MR. MATSON: We don't know of any cases where -- an instance where somebody tendered a note for payment

and wasn't paid. So that issue was never involved in the case we had below which was basically --

QUESTION: Right. But --

MR. MATSON: -- a securities --

QUESTION: -- we have to look at the notes and determine what they are and what was intended. And I -- it -- it suggests, at least, a version of understanding that for these notes the maturity was when the demand was made.

MR. MATSON: It also suggests, Justice O'Connor, that this is not a securities instrument. In a lending-type note, that's not uncommon language to find. That if you don't pay when due or when demand, you pay attorney's fees.

I can't ever remember, in a case or otherwise, seeing that kind of language attaching to a securities instrument. It may be possible in --

QUESTION: Well, they were certainly --

MR. MATSON: -- very special situations.

QUESTION: They were certainly advertised as investment --

MR. MATSON: They were.

QUESTION: -- obligations.

MR. MATSON: And what the -- no one knows the source of that ad. This program lasted some 25 years and

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that ad, in a very similar form, what's at page 5 of the joint appendix, appeared.

Now, first, the characterization by the cooperative of these notes as investments can't be determinative of the definitional question.

Further, investment can mean a lot of things. We invest in gold. We invest in art. We invest in houses. Those aren't securities.

In this case the members of the Co-Op were, we understand, by and large farmers in the Van Buren area who used the Co-Op as one uses agricultural co-ops. That is, they sold the grain they produced through the co-op; they bought their supplies from the co-op. So they were part of the co-op for all those normal purposes.

The -- the advertisement, which is an advertisement -- is a notice -- I don't quite know. But it appeared only in the Co-Op's newsletter. So the question earlier about the public -- yes, there were 1,600 note holders. We understand most of them were members of the Co-Op and there's a certain logic to that because if the notice about the notes appears only in the Co-Op's newsletter that goes to the Co-Op's members, those are going to be primarily the people who see the note.

The only individuals who are identified in the case who were not members were people who do -- did

business with and were familiar with the Co-Op.

So, the characterization simply can't be dispositive, nor can the fact that there were 1,600 holders of the note.

This Court in its Forman decision dealt with an instrument that was held by 15,000 people, that it held what was labeled stock was not a security.

In the Court's Landreth decision, it dealt with an instrument that was held by one person and it was a security.

The securities laws were never intended, as this Court has said, to regulate all fraud. And the number of people who may hold an instrument can't be determinative of that question.

In this instance we're dealing with the Securities Exchange Act of 1934. Protection comes to people who hold short-term securities fully under the Securities Act of 1933. In this case, because short-term notes were not traded, there was no need definitionally under the 1934 act to include short-term notes.

So, the statute excludes from the definition all notes with maturity of less than nine months, which, whatever other anomalies there may be with demand instruments, seems clear under at least the law that we've offered -- and there's been none offered on the other

side -- that demand is immediate and -- I'm sorry, there is a suggestion in, I believe it's the government's brief, that in a 1961 SEC release on commercial paper they suggested that demand was not immediate maturity. They based that on a Federal Reserve position taken years earlier.

The Fed, in 1966, reversed that position. The Fed has said since 1966, demand instruments have immediate maturity. The SEC has simply not had occasion to revisit it.

So, whether one looks at state law, as we believe is appropriate here, or to those analogous sources of federal law, would suggest that the demand notes maturing upon issuance are squarely within the plain language of the statute. The plain language should be applied to exclude these instruments from the definition.

QUESTION: Well, on your -- on your reading of the exclusion a commercial paper or a bank loan of more than nine months would be covered?

MR. MATSON: Under the statutory -- under the exclusion language, yes. If the note is more than nine months, it would not be covered by --

QUESTION: It would not be excluded?

MR. MATSON: -- by the exclusion. And then we would go to the other analysis we talked about, what is

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reasonable under the circumstances. Was the instrument intended to be a security? A straight commercial bank note would not be another type of note -- would be analyzed, we suggest, under the Landreth test, the two stages, to determine if it is a security.

Thank you very much.

QUESTION: Thank you, Mr. Matson.

Mr. McCambridge, you have four minutes remaining.

REBUTTAL ARGUMENT OF JOHN R. McCAMBRIDGE

ON BEHALF OF THE PETITIONERS

MR. McCAMBRIDGE: Justice O'Connor, nine courts of appeals have rejected Arthur Young's test on short-term notes. No court of appeals has accepted it.

Two courts of appeals --

QUESTION: Well, did all of them say that this type of note was not within the nine-month exclusion?

MR. McCAMBRIDGE: I was addressing whether the exclusion was limited to commercial paper. I was addressing Arthur Young's argument.

No -- two courts have dealt with demand notes, two courts of appeals. Both have concluded, first, that it's a commercial paper exclusion. And the most recent being the Holloway case, which was just decided by the Tenth Circuit in 1989. This is still a live issue.

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Second, in the Zeller case by Judge Friendly, he specifically said, I'm not going to decide whether demand notes are within the exclusion or not, but I'll pretend that they are.

QUESTION: What did the two courts decide that did deal with the demand note?

MR. McCAMBRIDGE: That they were securities. They were widely offered as investments, the things that we say should matter.

QUESTION: They were not excluded by them?

MR. McCAMBRIDGE: Correct. That's correct, Your Honor.

QUESTION: The -- the Securities Act definition of commercial paper, which we've been told is -- is the same as the words used here, it really isn't. The government sort of -- it's in footnote 12 of the government's brief, but the government does acknowledge that in the Securities Act there is added to this -- this recitation of notes and so forth that they have to be used for current transactions.

And that language is not contained in the exchange act. So, why -- why should one think that the two are meant to represent the same thing?

MR. McCAMBRIDGE: That is the single exclusion. The rest of it is identical. There is no legislative

history as to the reason for the omission.

Now, there's two possibilities. One, Congress meant to exclude only short-term commercial paper not offered to the public. Or, what Arthur Young says, which is Congress also meant to exclude short-term investment notes widely offered to the public.

We suggest, and I think Judge Friendly has indicated, that interpretation is inconceivable because the Senate and the House said the definitions of security in the '33 and '34 Acts are substantially the same. Our reading of it, the reading that every court of appeals has given it, is consistent with that.

Those two definitions of securities are substantially the same. The only thing out are notes not offered to the public that are commercial paper.

Their reading, I suggest, would create two definitions that would be widely different and there's no basis for it, no history to it, and it is incomprehensible that that's what they wanted to do.

Arthur Young's alternative test -- the number one -- here's where they say context does matter. They admit it. And what is the most important factor, the one that is brought up again and again? Where did you buy the note? Did you buy it in a stationery store or did you get it from a lawyer?

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That is -- what possible difference could that make? It is a ridiculous factor that was pulled out solely for this case.

CHIEF JUSTICE REHNQUIST: Thank you, Mr. McCambridge.

The case is submitted.

(Whereupon, at 2:00 p.m., the case in the above-entitled matter was submitted.)

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BY Lyona M. Mayo

(REPORTER)